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Section 112(b)(7) Liquidations

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SECTION 112(b) (7) LIQUIDATIONS

By

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The choice of form of organization for the conduct of business engages the attention of the owners principally when the enterprise is initiated. As conditions and circumstances change, the factors which dictated the choice may be re-examined. Aside from any consideration of the effect of income taxes, the corporate form offers a combination of advantages not available to other forms of business organization. Continuity of existence, limited liability, transferability of interest, convenience of financing and flexibility of control are desirable characteristics of the corporation. Some of these, but not all, are inherent in either the individual proprietorship, the partnership, the syndicate, the trust or other forms of joint ownership.

From the viewpoint of income taxes, a variety of circumstances will determine whether the corporate form of operation is more costly than other available forms of organization. Ordinarily the earnings of corporations are doubly subjected to the Federal income tax before they can be made available to the shareholders. The tax is first imposed on the income when earned by the corporation. After earnings are distributed in the form of dividends, they are again taxed as income of the shareholders. On the other hand, in situations where corporate earnings are required to be accumulated for the reasonable needs of the business, the second tax may be indefinitely postponed. Where the shareholders of such corporations have other large income so that the graduated rates at their top tax brackets are higher than the rates on corporation income, the immediate tax on the earnings will be lower than if the business were conducted under one of the other forms. This is often the case at the time of the formation of a corporation.

However, circumstances are not constant. The relative rates of individual and of corporate tax may change. The amount of income and consequently the tax "brackets" of the corporation and of the stockholder may vary. The need or desirability of accumulating the earnings may recede. This often occurs as the enterprise prospers. The surtax for unreasonable accumulation of earnings[1] may be an added factor influencing the desirability of dividend distributions.

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[1] Internal Revenue Code Section 102 imposes a special surtax on undistributed profits accumulated for the purpose of avoiding the taxes which would be imposed on shareholders if they were distributed as dividends. Accumulation of profits beyond the reasonable needs of the business raises a presumption that the purpose is to avoid the tax on shareholders. The rate of the surtax is 27-1/2% of the first $100,000. and 38-1/2% of the excess of net income over taxes and dividends, with certain adjustments detailed in the statute.

A typical illustration of this change of circumstances may be found where the business revolves about the ownership of real estate. A group of individuals with large income acquires a hotel or apartment house encumbered with a large mortgage debt. Earnings will be required to amortize this debt and will not be available for distribution to the owners until the obligation is discharged. If a partnership were formed, the earnings would be subjected to tax at the high rates applicable to the individual. Corporate rates are substantially lower. Hence a corporation is formed to take title to the real estate and operate the venture. Over a period of years the anticipated earnings are realized and the mortgage is discharged. There is no longer any reasonable need for accumulating surpluses. The earnings must be distributed or become subject to the Section 102 surtax. At that point the stockholders would rather have a partnership.

When income tax rates are high, the tax factor is probably the most important consideration affecting the choice of form of organization. When there is a substantial change of rate or when a special tax, such as an excess profits tax, is imposed, there is an accompanying swing toward or away from the corporation. This, of course, does not apply to large enterprises with widespread ownership interests which could not practically be operated in any other form. It does apply to the closely held or family enterprise.

During World War II the advent of an excess profits tax[2] on corporate income, with effective rates as high as 85.5%, was followed by a flight from the corporation to the partnership and the individual proprietorship. After the war, when the excess profits tax was repealed and income tax rates were reduced,[3] the trend was reversed. Now that rates have again been increased[4] and a new excess profits tax on corporate income has again been introduced into the revenue laws,[5] it may be confidently expected that the corporation will again fall into disfavor.

It would be nice if shareholders could, at will, change the form of their business organization to serve their desire for tax economy. But, ordinarily, a change from corporation to partnership or individual proprietorship may not be accomplished without tax consequences. In this respect the liquidation of a corporation differs from the formation of a corporation.

Upon the formation of a corporation the assets of a business may be transferred to it in exchange for the issuance of stock, without recognition of

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2 Second Revenue Act of 1940, Section 201; Excess Profits Tax Amendments of 1941; Revenue Act of 1941, Section 201, et seq.; Revenue Act of 1942, Section 201 et seq.; Revenue Act of 1943, Section 201 et seq.; Tax Adjustment Act of 1945.

3 Revenue Act of 1945, Section 121, 122.

4 Revenue Act of 1950.

5 Excess Profits Tax Act of 1950.

gain or loss.[6] But there is no similar provision for non-recognition of gain when the reverse occurs and the properties and assets are returned to the individual shareholders. The liquidation of a corporation by distribution of its assets in kind to shareholders is treated as an exchange of the assets for stock.[7] The basic rule prevails that upon an exchange the shareholder has gain or loss measured by the difference in value of the assets received by him and his tax basis for the stock.

This gain or loss is capital gain or capital loss and is short or long-term, depending on the holding period of the stock owned by the shareholder. It is short-term if the holding period is six months or less, and long-term if in excess of six months. Long-term capital gains receive the well-known favored treatment of a maximum rate of 25%.[8]

There are two exceptions to this rule. One applies where 90% or more of the stock is owned by another corporation, in which event the subsidiary transfers its assets to the parent corporation in liquidation without recognition of gain to the parent.[9] The other exception is where the liquidation occurs pursuant to a tax-free reorganization.[10]

The tax consequences of a liquidation may be so severe as to preclude a change of the form of the business organization, although the set-up is saddled with a burdensome tax structure. The corporation may have real estate, securities or other tangible assets with greatly enhanced but unrealized value. It may have valuable goodwill, trademarks or other intangible assets acquired upon tax-free incorporation or since incorporation. Such values, not yet realized, will be subject to tax under the ordinary rules relating to the liquidation of corporations. The stockholders might be faced with a substantial tax without receiving any cash with which to pay it. The valuation of such assets often presents problems, the solution of which cannot be reliably predicted at the time of liquidation so that there is no certainty as to the extent of the tax.[11]

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6 Internal Revenue Code, Section 112(b)(5) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons own at least 80% of the issued stock. If the transfer is by more than one person, the provision applies only if the amount of stock and securities received by each is substantially in proportion to his interest in the property transferred.

7 Internal Revenue Code, Section 115(c) provides that "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock . . ." This was not always the rule. Prior to the Revenue Act of 1942 the statutory provisions regarding distributions in liquidation had been frequently changed. Liquidating dividends were at various times taxed as ordinary dividends. When they were accorded capital treatment, gains were sometimes taxed in full as short-term gains and at other times the present rules applied.

For the legislative history of corporate liquidations to 1942 see Darrell, *Corporate Liquidations and the Federal Income Tax* (1941) 89 U. OF PA. L. REV. 907.

8 Internal Revenue Code, Section 117(c).

9 Internal Revenue Code, Section 112(b)(6).

10 Internal Revenue Code, Sections 112(b)(3), (4) and Section 112(g); Mertens, LAW OF FEDERAL INCOME TAXATION, Section 9.85.

11 See Shelton, *Stockholder's Gain on the Liquidation of a Corporation When There is Goodwill*, in Proceeding of Seventh Annual New York University Institute on Federal Taxation 349 (1949).

A particular class of corporation which often drifts into this uncomfortable dilemma is the personal holding company.[12] Many of these companies did not start out as such but fell into this class as their ownership or character of earnings changed. Real estate companies, finance companies, and even companies engaged in industrial and commercial enterprise can become personal holding companies when the stock is closely held and a large percentage of annual income is derived from interest, dividends, rents, stock or commodity transactions, etc.[13] There have been cases where, due to the complexity of the Internal Revenue Code, officers and tax advisers failed to recognize that corporations were personal holding companies for a period of years.[14] The income of personal holding companies, after payment of the ordinary income tax rates, is subjected to a prohibitive special tax[15] unless distributed to shareholders or included in the income of the shareholders by way of consent dividends.

Section 112(b) (7)

On three occasions Congress has enacted legislation affording relief to the shareholders of corporations who desire to change their form of organization but are deterred by reason of appreciated value of assets.

In the Revenue Act of 1938[16] provision was made whereby shareholders could elect special treatment which would limit their taxable gain upon the complete liquidation of a domestic corporation taking place in the month of December, 1938.. Five years later the Revenue Act of 1943[17] re-enacted substantially the same provisions, effective for complete liquidations occurring within any one calendar month during 1944. Now, after a lapse of six years, the Revenue Act of

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[12] The personal holding company is a purely statutory concept. It is any corporation, except those expressly exempt, whose stock is owned by a limited group and whose income is derived from designated sources. If for any taxable year the stock ownership requirement and the income requirement are met, the corporation is a personal holding company for that year. The stock requirement is met where at any time during the last half of the taxable year more than 50% in value of the stock is owned directly or indirectly by not more than 5 individuals. For this purpose an individual is considered constructively to own the stock of various specified relatives, partners, fiduciaries, corporations, etc. The income requirement is that at least 80% of the gross income for the taxable year be derived from dividends, interest, royalties, annuities, certain stock, securities and commodity transactions, rents under specified circumstances and other circumscribed sources. See Internal Revenue Code, Section 500 et seq.

The purpose for which the corporation was formed is not determinative. It can be readily seen that a corporation may be a personal holding company in one year and not in another year.

[13] In Reliance Factoring Corporation, 15 T. C.——No. 81 (1950), a corporation engaged in the jobbing business since 1935 was unable to purchase enough merchandise in the war years of 1944 and 1945 to realize any operating profits, but received dividends from a subsidiary and thereby became a personal holding company for those years.

[14] See General Management Corp. v. Comm., 135 F.2d 882 (CCA 7, 1943); Hatfried, Inc. v. Comm., 162 F.2d 628 (CCA 3, 1946); Frederick Smith Enterprise Co. v. Comm., 167 F.2d 356 (CCA 6, 1948); Haywood Lumber & Mining Co., 178 F.2d 769 (CCA 2, 1950).

[15] The rates are 75% of the first $2,000. and 85% of the excess of the "undistributed subchapter A net income", which, roughly, is the net income less taxes and dividends, with various adjustments.

[16] Section 112(b)(7).

[17] Section 120, amended Internal Revenue Code, Section 112 by adding subsection (b)(7).

1950[18] makes the same elective provisions available for the year 1951. The provisions enacted in 1943 and the current provisions appear in the Internal Revenue Code as Section 112 (b) (7).

Limitation of Taxable Gain

Briefly stated, the benefit accorded by Section 112(b)(7) consists of the postponement of recognition of a portion of the shareholder's gain until subsequent disposition of the corporate properties distributed to him in liquidation.

The amount of gain taxed is limited to the greater of (1) the money and the value of stock or securities acquired by the liquidating corporation after August 15, 1950, and distributed to the shareholder, or (2) the shareholder's ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913 to the close of the month in which the liquidation takes place.

Accumulated earnings of the liquidating corporation will not escape the double taxation of corporate earnings which is inherent in the income tax structure. But the time of taxation of potential and as yet unrealized profit in the form of increased values will not be accelerated as in an ordinary liquidation.

Where the money distributed exceeds the accumulated earnings, there is, to that extent, no reason for postponement of tax. It must be taxed at the time of distribution or escape taxation thereafter. Treating stock or securities, acquired after August 15, 1950, the same as money is for the purpose of preventing the easy avoidance of tax by conversion of money into stock or securities just prior to liquidation.[19]

There is no effort made in the statute to prevent other use of money which might have the same effect. It would seem that money could be used to pay debts or to acquire assets other than stock and securities. To the extent it were so used it would not be distributed. In a case where the corporation's cash exceeds its accumulated earnings and there is outstanding indebtedness, the cash and other assets could be distributed subject to arrangement by the shareholders for payment of the debt by assumption of liability or otherwise. An alternative course would be for the corporation to dispose of its cash by paying it out to reduce debt. The latter course would reduce the tax attending the liquidation.

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18 Section 206. This section was introduced into the Revenue Act of 1950 by the Senate. The reason for the provision is stated in the Senate Finance Committee report as follows: "This election will facilitate the liquidation of certain domestic corporations, especially domestic personal holding companies. Your Committee recognizes the undesirable character of domestic personal holding companies and wishes to expedite their liquidation." Although the provision may be primarily addressed to personal holding companies, it is available to any domestic corporation.

19 In the report of the Senate Finance Committee the following statement appears relating to this provision: "To avoid conversion of the assets of the corporation into stock or securities which could be distributed tax free in anticipation of legislative action restoring section 112(b)(7), the basic date referred to above, is made August 15, 1950, the date when this legislation was approved by your committee." 81st Congress, 2nd Session, Senate Report No. 2375.

In the Revenue Act of 1938 the basic date was April 9, 1938. In the Revenue Act of 1943 it was December 10, 1943.

The statute provides that the earnings and profits of the liquidating corporation are to be accrued to the date of completion of the transfer of all of its properties.[20] This applies to corporations which use the cash receipts and disbursements method of computing income as well as to those on the accrual basis. It is intended, thus, to avert the escape from taxation of such open items as would not be includible in income by cash basis taxpayers.

The treatment accorded to the gain taxed under Section 112(b)(7) differs as between corporate[21] and non-corporate shareholders.[22] The entire recognized gain of a corporate shareholder will constitute capital gain. For a non-corporate shareholder, such as an individual, trust or estate, so much of the recognized gain as consists of the share of earnings and profits will be considered dividend income. The remainder of the recognized gain, if any, consisting of the excess of the money, stock or securities received over the share of earnings and profits will be taxed as capital gain.

The reason for the different treatment accorded the recognized gain of corporate shareholders is the 85% dividends received credit. Corporations which receive dividends from other domestic corporations are entitled to a credit of 85% of the amount thereof in computing income subject to tax.[23] Only 15% of such dividends are taxed. Hence if any of the gain which it would derive from the liquidation of another domestic corporation were treated as dividend income, the applicable tax would be lower than if such gain were treated as capital gain. Thus it is that Section 112(b)(7) does not treat any of the gain of a corporate shareholder as dividend income.

This is one of the rare instances where a type of ordinary income is preferable to capital gain. However, with timely planning, it would seem that in many cases the capital gain of corporate shareholders could be reduced and dividend income correspondingly increased. Where a corporation having accumulated earnings and cash would distribute a cash dividend prior to adoption of the plan of liquidation, the corporate shareholders would get the 85% dividends received credit and incur lower income tax liability than if the cash were distributed as a liquidating dividend. Non-corporate shareholders would not be affected because their dividend income would be the same if they received the cash prior to or during liquidation.

In computing the tax the first step is to determine the gain to each shareholder, corporate and non-corporate, under the ordinary provisions of the Code relating to liquidation. This may be called the actual gain. The recognized gain of a shareholder under Section 112(b)(7) cannot exceed the actual gain. It may be less, but not more.

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20 This provision first appeared in the 1943 Act and is retained in the 1950 Act, Sections 112(b)(7)(E)(i) and 112(b)(7)(E)(ii).
21 Section 112(b)(7)(F).
22 Section 112 (b)(7)(E).
23 Internal Revenue Code, Section 26(b); Section 13(a)(2)(A)(i); Section 15 (a)(1)(A).

The actual gain may vary as between shareholders by reason of the fact that the basis of the stock in the hands of shareholders may differ. Some shareholders may have acquired their stock at a higher or lower cost than others. Stock may have been acquired by gift or by inheritance or as a tax-free dividend, or otherwise. When acquired other than by purchase, the determination of the tax basis may require careful study.

Next should be computed the earnings and profits of the corporation accumulated from March 1, 1913 to the close of the month in which the liquidation occurred. From this may be determined the ratable share of each shareholder in such earnings and profits. It is then necessary to ascertain the value of the stock and securities which each shareholder receives in the liquidation and which had not been owned by the corporation on or prior to August 15, 1950. To this value should be added the amount of money which each shareholder receives. The three significant amounts are then known with respect to each shareholder, namely, (1) the actual gain, (2) the ratable share of earnings and profits, and (3) money plus certain stock and securities received.

With respect to a non-corporate shareholder, the ratable share of earnings and profits, not to exceed his actual gain, will be dividend or ordinary income. If this does not consume the actual gain, then the excess of the money, stock and securities over the ratable share of earnings and profits will be taxed as capital gain to the extent of the unconsumed remainder of the actual gain.

The corporate shareholder merely compares the total money, stock and securities received by it with its ratable share of earnings and profits. The larger of the two will constitute capital gain, limited by the amount of its actual gain.

It is significant that the money and stock taxed are described as "the portion of the assets received . . . consisting of", etc., whereas the earnings and profits which are taxed are described as "ratable share of" etc. The statute anticipates that the distribution of assets in kind may not be alike to all shareholders. Some shareholders may receive one form of property and other shareholders another form. Insofar as concerns the taxing of earnings and profits, each shareholder is treated as having received his or its exact share, whether or not it is so in fact. With respect to money, stock and securities distributed, each shareholder is treated as receiving what he actually gets. This might lend itself to some planning with the view of minimizing tax. If one shareholder has a high basis for his stock, and consequently no gain upon the liquidation, he could receive cash and securities without incurring any tax liability. Another shareholder with low basis for his stock, and a consequent large gain, could receive other property, the gain on which would not be recognized. If this were the case with just two share holders owning all of the stock of the corporation and intending to continue the business as a partnership, it would seem that they could control the tax consequences to some extent. After the liquidation they could contribute to the capital of the partnership exactly what they had received from the corporation, and it would be immaterial which one had received money, other than the effect on their individual taxes and possibly on the basis of the assets to the partnership.

It will be seen that corporations without accumulated earnings and profits and without any recently acquired cash, stock or securities can be liquidated under Section 112(b)(7) without incidence of tax. Personal holding companies, which have either distributed their earnings by way of dividends or have capitalized their earnings by the use of consent dividends, usually have no substantial accumulations of earnings and profits and will find the section useful. Shareholders of other types of corporations desiring to abandon the corporate form must carefully compute the resulting tax under each of the two alternative methods available for liquidation before deciding whether to liquidate and, if so, which method to elect. In computing the tax, consideration must be given not only to the gain which will be recognized on the liquidation, but also to the future tax effects on resulting changes of the tax basis of corporate properties. The matter of basis and its implications will be discussed later.

It should be observed that Section 112(b)(7) relates only to gains. There is no reference in the statute to losses. Thus losses sustained by shareholders upon complete liquidation of a corporation are governed by the other provisions of the Internal Revenue Code and are not affected by Section 112(b)(7). A liquidation may result in gain to some shareholders and loss to others. The gains may receive Section 112(b)(7) treatment while the losses will be fully recognized.

Types of Liquidation which will Qualify

The type of liquidation which will qualify is described in the statute which states the following requirements:[24]

1. Property distributed in complete liquidation of a domestic corporation.
2. The liquidation is made in pursuance of a plan of liquidation adopted after December 31, 1950.[25]
3. The distribution is in complete cancellation or redemption of all of the stock.
4. The transfer of all of the property under the liquidation occurs within some one calendar month in 1951.

Just what constitutes a complete liquidation may not be too clear. Liquidation of a corporation has been defined as "the process of winding up its affairs, realizing its assets, paying its debts, and distributing to its stockholders, as such,

[24] Section 112(b)(7)(A).
[25] Section 112(b)(7)(A)(i).

the balance remaining".[26] A complete liquidation would seem to take place when the process is completed. When considered in connection with the provision that the transfer of all of the property under the liquidation must occur within one calendar month, it would seem that the liquidation contemplated by Section 112(b) (7) is one where transfers or distributions to shareholders must all occur and be completed within the one month, although the cessation of business, the payment of debts, the sale of properties and the other activities incident to a winding up of affairs may begin prior to that month. Some of these activities might even continue after the particular month.

It is not necessary that the corporation be dissolved in accordance with the laws of the state of incorporation; surely not within the month of the distribution,[27] or, probably, at any time.

Practical difficulties may arise impeding completion of distribution of all assets within a single month. Debts of the corporation may not be fully ascertainable. There may be claims of value or other assets unkown at the time. If the corporation is engaged in a going business which the shareholders intend to continue as a partnership, there will be a constant flux of transactions continuing to the time of transfer. In such a case there will be no liquidation of the business in the traditional sense of cessation and conversion to cash.

These practical difficulties may be solved variously. Perhaps the simplest method is to employ broad, all-inclusive instruments and thus transfer all properties and assets, in whatsoever form they may be, tangible and intangible, either to the shareholders jointly or to the partnership which they have formed. The transfer may be by undivided interests in all properties and assets to each shareholder. In any event the problem of ascertaining and paying all debts may be circumvented by making the transfer subject to assumption of corporation debt (ascertained and unascertained at the time) by the shareholders. In cases where provision for payment of debt cannot be made in this fashion, retention by the corporation of a reasonable amount of cash for this purpose and a subsequent distribution of the excess will probably not disqualify the liquidation under Section 112(b) (7). The regulations[28] recognize this and provide that the liquida-

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[26] C. M. Menzies, Inc., 34 B. T. A. 163, 168 (1936); also see John Milton, 33 B. T. A. 4 (1935); T. T. Word Supply Co., 41 B. T. A. 965 (1940); Edward B. Alford Est., et al, 3 T. C. M. 232 (1944); Mary Dupont Faulkner, 3 T. C. 1082 (1944).

Regulation 111, Section 29. 112(b)(7)-1(b), promulgated under the similar provisions of the 1943 Act, defines liquidation as follows:

> "A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders."

[27] The Regulation (cited in footnote 26) states "Though it is not necessary that the corporation dissolve in the month of liquidation, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation." It further provides "If a transaction constitutes a distribution in complete liquidation within the meaning of the Code and satisfies the requirements of section 112(b)(7), it is immaterial that it is otherwise described under the local law."

[28] Regulation 111, Section 29. 112(b)(7)-1(b).

tion will not be disqualified "if cash is set aside under arrangements for the payment, after the close of such month, of unascertained or contingent liabilities and expenses and such arrangements are made in good faith and the amount set aside is reasonable."

Aside from cash retained to pay debts, is it necessary that all property, without exception, be transferred during the one month? Will a later distribution of a portion of the assets defeat qualification of the liquidation under the statute? This question arose in a recent case[29] where a liquidation was sought to be disqualified by reason of a late delivery to shareholders of certificates of stock comprising about 6% in book value of the distributed assets. The Tax Court held that there was compliance with the statute. It reasoned that the regulation, which was held to be reasonable, permits compliance with the statute without actual transfer of all property when it allows cash to be retained to pay debts; that "the accent is placed upon liquidation so much that it appears that if the first distribution is made during a status of liquidation which continues to the date of dissolution, the statute is construed as satisfied"; and that it would therefore be out of line with the regulations to hold that mere failure to deliver physically less than 6% of the assets would destroy the election.

It is not entirely clear from the opinion whether the Tax Court adopted the broad rule that a first distribution during the month and a continuing status of liquidation thereafter to dissolution is sufficient, or whether the rule is one of substantial compliance and that a distribution of the bulk of the assets during the month with a later distribution of a small balance will suffice. The latter is probably a sounder construction of the statute. But it is not safe to rely on either rule. Taxpayers generally can, and should comply with the literal provisions of the statute regarding distribution of all properties and assets within a single calendar month.

Election of Shareholders

The provisions of Section 112(b)(7) are wholly elective and will only apply to such shareholder as is a "qualified electing shareholder" as defined in the statute.[30]

The only type of shareholder that cannot qualify is a corporate shareholder which, at any time between August 15, 1950 and the date of the adoption of the plan of liquidation, owned 50% or more of the stock entitled to vote on the adoption of the plan. Such a shareholder is termed an "excluded corporation".

[29] Lewis B. Meyer Est., 15 T. C.——, No. 109 (1950) in which a shareholder, who had filed an election to have his gain from a 1944 liquidation taxed under Section 112(b)(7), contended that there was a lack of compliance with the statute and that his gain should be determined under Section 115(b).
[30] Section 112(b)(7)(C).

A "qualified electing shareholder" is defined as any shareholder, other than an "excluded corporation", who owns stock of the liquidating corporation at the time of the adoption of the plan of liquidation, and whose written election to have the benefits of the section is filed, and provided that a designated percentage of the owners of voting stock file such elections. The qualification regarding the amount of voting stock owned by shareholders electing to come within the section distinguishes between corporate shareholders and non-corporate shareholders.

In order that any non-corporate shareholder be considered a "qualified electing shareholder", it is necessary that written elections be filed by non-corporate shareholders who, at the time of the adoption of the plan of liquidation, possessed at least 80% of the total combined voting power of non-corporate shareholders entitled to vote on the adoption of the plan of liquidation. A corporate shareholder may only be a qualified electing shareholder if, exclusive of excluded corporations, written elections are filed by corporate shareholders possessing at least 80% of the combined voting power of corporate shareholders entitled to vote on the adoption of the plan.

Each constitutes a separate class for the determination of qualification under the statute. If the holders of at least 80% of the stock owned by non-corporate shareholders elect to come within the section, the benefits of the section become operative as to all shareholders (other than corporations) who elect. Of course, those who do not elect will be treated under the other provisions of the Code.

Likewise, the section only becomes operative for corporate shareholders if those who own at least 80% of the stock file elections. In computing this 80%, stock owned by an excluded corporation is not considered.

Thus there can be a liquidation in which only non-corporate shareholders will qualify under Section 112(b) (7) or in which only corporate shareholders will qualify. There can even be a situation where certain corporate shareholders will qualify and one corporate shareholder will not qualify. If there is a shareholder owning a class of stock which is not entitled to vote on the adoption of the plan of liquidation, such a shareholder might nevertheless be a qualified electing shareholder.

It should be observed that the 80% rule applies to shareholders entitled to vote on the adoption of the plan of liquidation. If the required amount of non-corporate shareholders possessing such voting rights elect to come within the section, then all non-corporate shareholders owning any class of stock may qualify by filing elections. This also applies to corporate shareholders as a class, with the exclusion, of course, of "excluded corporations."

The regulations[81] amplify the statute and provide that since the election relates to the treatment of gain, it can only be made by the person who may realize gain. An actual owner of stock may make an election. A mere record holder, such as a nominee, may not. The regulations further provide that the election is personal to the shareholder making it and does not follow such stock into the hands of a transferee. Thus a purchaser of stock of a corporation, which adopted a plan of liquidation prior to the purchase, may not have the benefits of Section 112(b)(7).

The question has been raised whether an election to have gain on liquidation treated under Section 112(b)(7) is binding or may be revoked. In the report of the Conference Committee on the 1938 Act it was stated that the election could not be withdrawn or revoked. The regulations have a similar provision.[82] The Tax Court has held the regulations to be valid and refused to permit taxpayers to revoke their elections.[83]

How Election is Made

The statute provides that the election must be filed within 30 days after the adoption of the plan of liquidation and must be made and filed in such manner as prescribed by Treasury regulations.[84]

The regulations governing the making and filing of an election are concise and plain. The election is to be made on Form 964 in accordance with instructions printed thereon. The original and one copy are to be filed with the Commissioner of Internal Revenue at Washington. A copy is to be attached to the shareholder's income tax return for his taxable year within which the transfer of the property occurred.

Effect on Basis

A most important factor bearing on the benefit to be derived from an election under Section 112(b)(7) is the effect of the non-recognition of gain on the basis of the property received in liquidation. In a fully taxable liquidation under Section 115(c) the basis of the property received by the shareholder is the value thereof at the time of distribution.[85] In a 112(b)(7) liquidation the basis

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81 Regulation 111, Section 29.112(b)(7)-2.

82 75th Congress, 3rd Sess., H. Rept. 2330; Regulation 111, Section 29.112(b)(7)-2(1).

83 Lewis B. Meyer, Est. *supra,* note 29, where earnings and profits to be treated as dividend income were erroneously computed and turned out to be about $800,000. more than had been anticipated; Sam Goldman, 9 T. C. M. 936 (1950) where the taxpayer apparently was ignorant of the elections available to him and made no computations in advance of signing and filing the election form.

84 Section 112(b)(7)(D). See Regulation 111, Section 29.112(b)(7)-3.

85 See Blum, *Changing from a Corporation to a Partnership,* in TAXES—THE TAX MAGAZINE, Vol. 28 No. 12, 1180 (1950); Geller, *Effect of Change in Basis of Inventory Received from Stockholders of a Liquidated Corporation* (In Hands of Successor Partnership Transferee), in Proceedings of Seventh Annual New York University Institute on Federal Taxation, 418 (1949).

will be the same as the stock cancelled or redeemed in the liquidation, minus the amount of money received and plus the amount of gain recognized.[36]

Where the property distributed consists of more than one class of property, as is usually the case, the basis is allocated among the several properties in the proportion that the fair market value of each bears to all.[37]

This is a logical consequence of the postponement of recognition of gain and follows the pattern established for other tax-free exchanges. Where there is an exchange without recognition of gain, the property received succeeds to the basis of the property transferred. A later disposition, in a taxable transaction, of the property received will thereby subject the entire gain to tax. Appreciation of value will not ultimately escape tax.

Although the theory is equitable, in practice the careless taxpayer may suffer unforeseen consequences. Consider the case of a corporation with no cash, stock or securities but owning real estate with appreciated value, valuable goodwill, large inventories worth cost and no accumulated earnings and profits. The stock had been acquired by its shareholders by purchase at a cost much lower than present value. The shareholders could liquidate this corporation by transferring all of its assets to a partnership formed by them and, by electing under Section 112(b)(7), incur no tax liability from the transaction. But the basis of the stock becomes the basis of the properties acquired by the partnership. This basis will be distributed among real estate, goodwill and inventories in proportion to their respective values. In the process the basis of inventories will be decreased below cost. As these inventories are sold by the partnership, that reduction of basis will be reflected in increased profit which will be taxed as ordinary income.

A similar result may follow where the corporation distributes accounts receivable, notes or other obligations which, when collected, will yield ordinary income.

A reduction of basis of depreciable property will be followed by reduced deductions for depreciation. A corporation with no undistributed earnings and owning but a single asset—real estate—might appear to be a likely candidate for a 112(b)(7) liquidation. But if it has a substantial basis for its buildings, whereas the stock was acquired by its stockholders at low cost so that the basis for the stock is much less than the basis of the buildings to the corporation, a liquidation under 112(b)(7) will result in loss of depreciation deductions.

The effect of a 112(b)(7) liquidation on the basis of corporate properties will not always be adverse. In some cases basis will be increased. If, in the illustration given above, the stock had been purchased at a price which fully reflected the appreciated value of the real estate and the value of the goodwill so that the

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[36] Internal Revenue Code, Section 113(a)(18).
[37] Regulation 111, Section 29.113(a)(18)-1(b).

basis of the stock was greater than the basis of the corporate properties, then the partnership will have a higher basis for the properties. This will yield greater depreciation deductions on buildings.

Tax conscious shareholders, considering abandonment of the corporate form for the conduct of their business, should be fully informed before making a choice. Depending upon the circumstances, liquidation under Section 112(b)(7) rather than under Section 15(c) may result in lower or greater immediate tax, and may be followed by lower or greater taxable income in future years, wholly unrelated to economic earnings. The results should be carefully computed, or at least estimated, after a detailed study of accumulated earnings and profits and the effects on basis. Not until this is done can the shareholders appraise the merit of changing their form of business organization and intelligently exercise their election of alternative courses available under the Internal Revenue Code.